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SYMPOSIUM 1999
Women, Equity and Federal Tax Policy: Open Questions

Keynote Address: Marriage Penalties and Bonuses in the Federal Income Tax

*June O'Neill**

The income tax system in the United States is not marriage neutral. According to estimates of the Congressional Budget Office (CBO) about 22 million married couples will pay higher taxes this year than they would if they were single. They will pay a marriage penalty, averaging close to $1,500 per couple. Less well known is that another 26 million couples will get a marriage bonus. The taxes paid by these couples are lower by about $1,600 per couple as a consequence of marriage. In recent years the number of married couples incurring marriage penalties has increased, thus raising questions of fairness. But it is also important to consider efficiency, since the current tax treatment of families and individuals creates both work and marriage disincentives.

The country's long standing commitment to a progressive income tax is the underlying source of the problem. If taxpayers at all income levels faced the same tax rate — in other words, if the income tax was a proportional tax — there would be no marriage penalty or bonus. For example, at a 20 percent single tax rate, John Doe earning $30,000 a year could marry Jane who also earned $30,000, or Jill who planned to be a full-time homemaker, and his rate in either case would still be 20 percent. Jane's tax rate would stay the same if she married John or remained single. And, if instead, Jill married John and

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eventually decided to work, she would also face a 20 percent tax rate.

As long as we remain wedded to the principle of horizontal equity under a progressive tax system, marriage and work choices can significantly affect our tax liabilities. That principle calls for families with the same total money income to pay the same tax, implying that the tax unit should be the family, not the individual. For example, in a progressive system that taxed individuals based on their own earnings, a husband-wife family, with one worker earning $60,000, would pay higher taxes than the sum of the taxes paid by a husband and wife who each earned $30,000. And that would violate horizontal equity. Of course, it is not crystal clear that the principle of horizontal equity is equitable. Are two couples with the same $60,000 total money income really equally well off, if in one case the $60,000 is earned by one worker whose spouse is a full-time homemaker, while in the other case the husband and wife each work full-time earning $30,000?

Over the years, changes in both the income tax and the work patterns of married women have brought these issues to the fore. The federal personal income tax was introduced in the United States in 1913 and between 1913 and 1948 the law applied to individuals, all of who filed on the same progressive rate schedule, regardless of marital status. A progressive income tax levied on individuals, in principle would have violated horizontal equity. However, prior to World War II the income tax only applied to a very small proportion of the population, and two earner couples were rare. (The proportion of married women working outside the home was only 6 percent in 1900 and 14 percent in 1940.)

During World War II the federal income tax was greatly expanded in size and in progressivity. Once the war was over, pressures for a tax cut were intense. The vast majority of the taxpaying population consisted of husband-wife families with a single earner. Many of them were GIs and their brides, adding sentiment to support for a tax cut that would particularly benefit such families. Spurred by the example set in community property states, the idea took hold of allowing couples to file a joint return in which their combined income would be split in half, with taxes paid on each half regardless of the actual distribution of earnings between the spouses.

In 1948, the Congress codified income splitting for all couples in the form of joint filing. As a result, most married couples paid lower taxes then they would if they were single, and the marriage bonus was born. However, single taxpayers viewed joint filing not as a bonus for couples but rather as a "singles' penalty" which caused them to pay higher taxes than they would if they were married. Under growing pressure from single taxpayers, the Congress in 1969 altered income tax brackets to limit "singles' penalties," lowering taxes on individual returns relative to those on joint returns. That action created marriage penalties for some couples — those who were not getting bonuses — while continuing marriage bonuses for others.

Subsequent tax legislation has altered the size of penalties and the couples they affect. For example, the Earned Income Tax Credit (EITC), introduced in 1975, provided tax relief for low-income working families with children. But it also created a new source of marriage penalties for those families by failing to distinguish between one and two earner families.

In 1981, responding to pressure from the growing number of couples paying marriage penalties, the Congress reduced those penalties by enacting the two-earner deduction. The two-earner deduction allowed two-earner couples to deduct 10 percent of the earnings of the lower-earning spouse, up to $30,000. The two-earner deduction was eliminated by the Tax Reform Act of 1986. But embedded in the broad reform of the 1986 legislation was an alternative means of addressing the problem. This legislation cut the number of tax brackets from 15, with a maximum rate of 50 percent, to just two, with a maximum rate of 28 percent (33 percent in a certain range); it thereby flattened the tax rate structure sharply and reduced the incidence and size of marriage penalties and bonuses. However, the tax reform of 1986 did not last, and the addition of three rate brackets in 1990 and 1993 as well as a hike in the maximum rate, once again increased progressivity and with it increased the size of both marriage penalties and bonuses. Finally, the Taxpayer Relief Act of 1997 created additional marriage penalties for some, and bonuses for others, by phasing out eligibility for individual retirement arrangements and child and education credits over various income ranges.

Over the past 25 years, as a result of increases in the labor force participation and earnings of women, substantial shifts have occurred in the mix of taxpayers incurring penalties and receiving bonuses. Between 1969 and 1995, the fraction of working-age couples in which both spouses had paid employment increased from 48 percent to 72 percent. During the same period, the incomes of husbands and wives in two-earner couples became more nearly equal. In 1969, 17 percent of two-earner couples had each spouse contributing at least one-third of total earnings; by 1995, that share had doubled to 34 percent. Those two changes — an increase in two-earner couples and greater equality of spouses' earnings — occurred for couples at all income levels, in all age categories, and regardless of whether they had children. Greater equality of earnings between husbands and wives makes marriage penalties more likely and larger. As a result, the overall effect of those shifts in women's work participation and earnings has been to increase the number of couples incurring penalties and to boost the size of the average penalty.

At present, the distribution of marriage penalties and bonuses varies markedly across the income distribution. CBO estimates for 1999 suggest that only 14 percent of couples with income below $20,000 will pay penalties and 59 percent will receive bonuses. That situation occurs because only one-third of low-income couples have two earners. In contrast, more than three-fourths of couples with income above $20,000 have two earners. As income rises, the proportion of couples paying the marriage penalty rises. Among couples with total incomes of $100,000 or more, 56 percent are expected to pay a penalty; 44 percent will get a bonus.

WORK AND MARRIAGE DISINCENTIVES

The issue of inequities spurs much of the current concern about marriage penalties. Clearly it is not fair for two people to pay higher taxes just because they are married. However, we should also be concerned with penalties (and bonuses) because of the work and marriage disincentives they create. Joint filing generally causes the lower-earning spouse — usually the wife — to face a higher tax rate then she would based on her own earnings, filing on a single return. Such higher tax rates may induce people — particularly those with significant non-market alternatives (like child care) — to choose not to work or to work fewer hours. Moreover, that effect is reinforced by the fact that home production of goods and services for family consumption is not taxed at all.

Many empirical studies of labor market behavior have found that workers and particularly married women, respond to changes in their after-tax wage rates, choosing to work less when their take-home wage rate falls. Such responses to tax rates not only make affected couples worse off because their income is lower, but also reduce national output.

Furthermore, the prospect of facing a tax increase of several hundred dollars may induce some couples to delay or forgo marriage. At the same time, marriage bonuses may induce other couples to marry in order to reduce their tax bills. Economic studies indicate that such effects are small but statistically significant. Those responses are further indications of the serious and unintended effects of the income tax system.

OPTIONS FOR REDUCING OR ELIMINATING MARRIAGE PENALTIES

The changes in legislation and in women's labor market participation and earnings that have made marriage penalties larger and more common have brought renewed interest in reducing those penalties. However, the problem is difficult to fix and satisfying every goal and everyone's perception of fairness is not possible. Furthermore, changes that reduce marriage penalties can have impacts beyond the immediate goals of the legislation.

A variety of options would reduce marriage penalties. One approach that has been seriously considered in Congress would alter the current tax code by widening certain tax brackets and raising the standard deduction for joint filers to twice that for single filers. That would increase the standard deduction for couples from $7,100 to $8,500. CBO estimates suggest that this change would eliminate about 44 percent of the marriage penalty. But it would do so at an annual cost in terms of lost revenues of at least $25 billion in 1996 dollars. And it would be highly inefficient because more than half of the revenue cost would go to enlarge the marriage bonuses of couples already receiving them. For an additional cost of $4 billion — bringing the total to $29 billion — the entire marriage penalty could be eliminated if couples were allowed to choose between filing jointly or as individuals. All existing marriage bonuses would continue under that proposal, but they would not be enlarged.

A more limited and much less costly option would restore the 10 percent deduction on earnings up to $30,000 for the second earner (the provision in effect between 1982 and 1986). The revenue loss is estimated to be $9 billion and it would eliminate about one-third of the marriage penalty.

All marriage penalties and bonuses would be eliminated if income splitting was eliminated and all filers were required to file single returns. Such a dramatic change would have no cost to the Treasury (in fact it would increase revenues a little), but it would redistribute about $30 billion in tax liabilities from couples now receiving penalties to those now receiving bonuses. Because some 26 million couples (the current bonus recipients) would face a tax hike averaging more than $1,300 per couple, I would not predict easy passage of this proposal.

Finally, the flat tax, which would reduce many inefficiencies in the current tax system, would have the side benefit of eliminating (or close to eliminating) marriage distortions both of the penalty and bonus variety.

FAMILY ISSUES IN SOCIAL SECURITY

Many of the problems regarding the treatment of one and two-earner families in the income tax system, also apply to social security. Social security, through its tax and benefit structure, provides substantial subsidies to married couples in which one spouse has little or no covered employment. A wife who works in covered employment, however, will only benefit from the spouse provision if her own earned benefit is less than her entitlement as a dependent spouse or widow. But since social security taxes are levied on individuals, not families, the married woman will pay social security taxes on the same basis as everyone else, including men whose wives are homemakers.

Not surprisingly, money's worth calculations that estimate the lifetime return to social security as an investment, show a sharp decline in the net return to married couples' social security tax payments, as the work experience and consequently the tax payments of the wife increase. It is also difficult to justify the transfer to one-earner couples on welfare grounds, since it is based on homemaker status rather than evidence of need. The benefit amount is usually based on the husband's earnings and women who are homemakers tend to be married to higher earning men.

As with the marriage penalty, it is not easy to draft solutions for social security that seem likely to command a political consensus. But also like the income tax, side benefits to a reform that improves the efficiency of the program can help to rationalize the treatment of married individuals in social security. I am referring to a system of individual retirement accounts in Social Security, which in my opinion would offer a flexible mechanism for couples to decide for themselves how they wish to provide for the apportionment of retirement and survivor benefits.